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**THE WALL STREET JOURNAL.**

WSJ.com

HOUSE TALK | NOVEMBER 22, 2008, 10:48 A.M. ET

## Short Sale vs. Foreclosure

*In default and underwater on 12 properties, a reader wonders if selling at a loss is any better than just walking away*

By JUNE FLETCHER

**Q.** I am in default on 12 jointly-owned properties that I am trying to liquidate as part of a divorce. All of my properties are currently worth less than the mortgage balances, due to the tough real estate market. I am aware that I will likely be taxed for the amount of the mortgage I had that is not satisfied by any particular short sale. It seems that this would not be the case if the house is foreclosed on, or becomes bank-owned.

This almost encourages homeowners to allow foreclosure, rather than to participate in helping to sell the property (when there is no equity left), because there is not "an amount forgiven" to be taxed on. I recognize that the benefit of short-sale is to lessen the effect on one's credit report, but if a homeowner is already missing payments, how much worse will a foreclosure look?

**A.** Although you own an unusual number of homes, your dilemma in trying to choose between a short sale and a foreclosure is, sadly, not at all unusual these days. So I asked Craig Watts, public affairs manager of Fair Isaac Corporation in San Francisco, to comment on your case. Fair Isaac is the company that created the FICO score, used by lenders to assess borrowers' creditworthiness.

Mr. Watts said that the company assesses every negative on a credit report by three factors: recency (how recently did the negative event occur), severity (how late is the payment) and frequency (how many times you've been reported delinquent on credit obligations).

A recent bankruptcy does the most damage to your score. Mr. Watts adds that if lenders are reporting all of your mortgages as in default, the damage to your FICO score would be akin to declaring bankruptcy on all 12 accounts. For more information on credit scores and how they are calculated, visit the "credit education center" at [www.myfico.com](http://www.myfico.com).

Although a short sale, where the lender agrees to take less than owed on the mortgage, will drop your FICO score as much as a foreclosure will, there is one advantage to it: You may be eligible to buy a home with an institutional loan

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backed by Fannie Mae or Freddie Mac more quickly than you would if it went into foreclosure.

Lenders encourage short sales over foreclosures because they generally net more from them, since foreclosures incur additional marketing, legal, processing and carrying costs. (For details, see [Fannie Mae's announcement 0-82](#).) Borrowers can be considered for loans following a short sale after 24 months, if the sale was caused by extenuating circumstances outside of a borrower's control, or 48 months if it was the result of financial mismanagement on the borrower's part, according to Freddie Mac public relations director Brad German.

As for your tax situation: because of the Mortgage Forgiveness Debt Relief Act of 2007 and the recently passed Emergency Economic Stabilization Act, you can exclude up to \$2 million of income (\$1 million if married filing separately) from debt that's discharged through mortgage restructuring, or that's forgiven in connection with foreclosure, for the years 2007 through 2012. The exclusion must be connected with a decline in the home's value or the taxpayer's financial condition, and only applies to a principal residence, not investment properties. You can claim relief on your principal residence through [IRS form 982](#). However, Mike Martin, a financial consultant and tax advisor in Independence, Mo., notes that there may be other provisions in the law that can help you: For instance, if you are insolvent when your debt is cancelled, some or all of that debt may not be taxable.

Given the complexity of your situation, please don't try to resolve this situation on your own: Seek professional tax and legal advice.

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